Debt Buybacks, Defaulting Lenders And Libor Market Disruption

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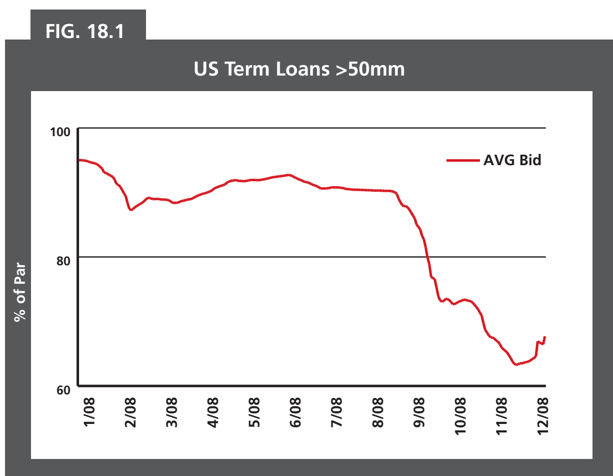
The financial crisis of 2008 resulted in market conditions that tested common terms and conditions in syndicated credit documentation. Two developments, debt buybacks and defaulting lenders, were simply not contemplated by the documentation. A third, LIBOR market disruption, had long been contemplated as a risk, but the provisions that had developed over the years did not protect lenders as effectively as they might have expected. This article discusses these three developments.

DEBT BUYBACKS

The turmoil in the credit markets in 2008 caused severe downward pressure on the secondary market prices of bank loans (see figure 1), and this was true not only for loans of distressed borrowers but also for borrowers that were relatively strong. The dramatic fall in prices created attractive financial opportunities for borrowers and their affiliates to prepay or purchase loans at a discount. By doing so, borrowers could deleverage at bargain prices, affiliates could profit from acquiring undervalued assets and, in some cases, financial sponsors could remedy defaults of their portfolio companies less expensively than by exercising equity cure rights.

FIG. 18.1



Source: LSTA/LPC MTM pricing

While the desires of borrowers and their affiliates in light of these conditions are understandable, and indeed would be commonplace in the context of publicly traded securities, they have created challenges in the bank loan markets. Aside from a brief flirtation with buybacks in Asia during that region's financial crisis in the late 1990s, they have been relatively unknown in the bank loan markets. As a result, many lenders have viewed them somewhat differently (if they have thought about them at all) than have investors in public securities, and buybacks have generally not been not contemplated by loan documentation.

An initial objection raised by many lenders was based on principle. It seemed unfair (bordering, in the minds of some, on immoral) to allow borrowers and their affiliates in effect to profit from lower secondary market loan prices at the expense of the very lenders that extended the loans in the first place. However (except when buybacks were proposed to be made with the proceeds of their own newly advanced loans), hard reality soon set in and it became difficult for lenders rationally to distinguish buybacks by borrowers and their affiliates from open market purchases by unaffiliated third parties, especially at a time of relative illiquidity for secondary market sales. Other concerns of lenders have persisted, and they are often addressed as conditions to the consents by lenders to allow buybacks to take place. Lenders generally require that the buyback process be fair, open to all lenders on the same basis and transparent, including assurance that material information has been disclosed. If lenders are concerned about a borrower or its subsidiaries using its or their own resources for the buyback and thereby depleting liquidity, they may insist that the buyback be made directly by, or with the proceeds of equity contributions from, other affiliates of the borrower. If it is anticipated that loans bought by affiliates remain outstanding, it is likely that lenders would require that the affiliates forfeit voting rights under the credit agreement and agree not to participate as a creditor in discussions with other lenders, in each case in order to avoid any taint resulting from a conflict. The lenders may also require that those loans be subordinated to the loans held by unaffiliated lenders or otherwise be treated as a separate, inferior tranche for certain purposes.

Documentation Constraints

As observed above, syndicated credit documentation historically has not contemplated the possibility of debt buybacks. Indeed, by design or otherwise, standard provisions in most credit docu-

mentation prohibit buybacks. As a result, it has generally been necessary for a borrower to obtain an amendment or consent from lenders in order for a buyback to occur. It is the need for such an amendment or consent that gives the lenders the leverage to require satisfaction of their requirements described in the preceding paragraph.

Before discussing in more detail the types of amendments or consents often required or requested, it may be useful to draw a distinction between the parties that may effect a buyback and to clarify what is meant by the term "buyback" for purposes of this article. Although the term "buyback" connotes a purchase or assignment of a loan, a buyback conducted by a borrower would generally be structured as a non-ratable voluntary prepayment under the credit agreement rather than as a purchase or assignment. There are several reasons for this, the principal one of which is that the concept of voluntary prepayments by a borrower (albeit ratable) is already generally provided for in credit documentation while purchases or assignments by the borrower might raise questions not as easily answered (such as whether as loans acquired by the borrower are still considered "outstanding" for various purposes of the agreement). On the other hand, when a loan is acquired by a subsidiary, parent company, equity investor or other affiliate of the borrower, the proper legal characterization of the acquisition would be a purchase or assignment. This distinction is important for legal reasons, because the restrictions in credit agreements for prepayments are different from those for purchases and assignments. However, for purposes of this article (and to be consistent with market convention), the term "buyback" is used to refer to both types of transactions.

Any form of buyback will permit but not require the participation of all lenders. Accordingly, the consummation of any buyback will not necessarily (and probably will not in fact) result in a buyback of loans of all lenders under a credit facility on a pro rata basis. In the context of a buyback structured as a prepayment by a borrower, the principal provisions of the credit agreement to be analyzed are those that require all lenders to be treated on a pro rata basis. Most importantly, these would include the "equal and ratable clause," which requires that voluntary prepayments of loans be applied on a pro rata basis to all loans of the same class, and the "sharing clause," which requires each lender to share with other lenders the benefits of any recovery in excess of its ratable share. If the buyback would otherwise violate either of these clauses (and experience demonstrates that it is highly likely that one or both would be violated), then an amendment or waiver would be required.

In the context of a buyback structured as a purchase or assignment, the most important provisions to analyze are the restrictions on assignments.[1] It is very common for a credit agreement explicitly to prohibit assignments to the borrower and its affiliates, in which case an amendment or waiver would be required. If the buyback is to be effected by a subsidiary of the borrower, it will also be necessary to consider whether the transaction would violate any investment restrictions or other negative covenants in the credit agreement that apply to subsidiaries. As noted above, if it is contemplated that loans remain outstanding after they are bought back, it is likely that lenders would impose conditions on their consents, especially in relation to voting and participation in creditor discussions. The lenders may also require that the loans acquired by affiliates be treated in effect as a separate, inferior tranche with terms that differ in some respects from those for the other loans. For example, loans held by affiliates might be subordinated, might have different amortization schedules or interest rates and might have different treatment in the context of mandatory or voluntary prepayments. To the extent that these different terms might otherwise have the effect of reducing the amount of principal payments or prepayments to be made by a borrower, it may become a matter of negotiation as to whether that amount should be applied to the loans held by non-affiliates or retained by the borrower for use in its business.

As we do elsewhere in this article, it is important to emphasize the importance of analyzing the applicable credit documentation carefully. Especially in the context of debt buybacks, the precise wording varies from transaction to transaction to an extent that some might consider surprising, and a subtle difference in language may make the difference between (a) no amendment or waiver being required, (b) an amendment or waiver being required with the consent of the "Required Lenders" and (c) an amendment or waiver being required with unanimous consent (or consent from "affected" or "directly affected" lenders). In the current environment, many lead arrangers regard the likelihood of obtaining unanimous consent on any proposed amendment or modification to be low. Even where only consent of the "Required Lenders" is required, some attempts to amend credit documentation to permit buybacks failed in 2008[2].

Types of Buybacks

Regardless of whether a buyback is structured as a prepayment

1 The sharing provisions of some credit agreements also need to be examined to determine whether they might intentionally or inadvertently cover assignments to borrowers and their subsidiaries or other affiliates.

2 According to press reports, such an amendment failed for Hanesbrands, for example.

or a purchase, there are two principal methodologies that have developed to determine the price and total amount of the loans to be prepaid or acquired. While there is no particular magic to using only these methodologies, the market has come to regard them as fair and transparent – two considerations of utmost importance to lenders.

If the buyback is launched as a fixed-price tender offer, the borrower or its affiliate, as applicable (referred to in this paragraph as the "Initiating Party"), specifies a price, and all loans tendered by lenders at that price are accepted. Alternatively, in a reverse or modified Dutch auction, the Initiating Party specifies a range of acceptable prices and either the total amount of loans it is seeking to purchase (or prepay) or the total purchase price (or prepayment amount) it is willing to pay. Each lender that wishes to bid tenders an amount of its loans that it is willing to include in the buyback and the price at which it is willing to offer those loans. The highest price is then determined that clears the market for the total amount of loans or total purchase price specified by Initiating Party. All lenders that tendered at or below that price will have their loans included in the buyback at that price. If the total amount of the loans tendered or the total purchase price (or prepayment amount) to be paid at that price would otherwise exceed the limits set by the Initiating Party (which limits may sometimes be increased at the discretion of the Initiating Party), the buyback procedures set forth an allocation mechanism to keep the buyback within those limits. Generally, the allocation would result either in all loans tendered at or below the market clearing price receiving ratable treatment or in loans tendered at the lowest prices being the first ones to be included in the buyback with the ratable cutback to be applied only to the loans tendered at the market clearing price.

Tax Considerations

Debt buybacks generally have tax consequences to borrowers and lenders. Lenders generally will recognize a loss for tax purposes in connection with a buyback at a discount, assuming the loan has not previously been written down. The borrower will recognize taxable "cancellation of indebtedness income" in an amount equal to the difference between the amount paid and the face amount of debt that is extinguished. More surprising to many borrowers, the borrower also has "cancellation of indebtedness income" if its debt is purchased by a person "related" to the borrower. The tax rules treat this as if the borrower had repurchased the debt itself for the actual purchase price (triggering the income) and then issued new debt to the related person (for an issue price equal to the actual purchase price), possibly causing the new debt to have original issue discount.

Legislation signed into law on January 17, 2009 as part of larger economic stimulus legislation, allows borrowers to defer taxes on cancellation of debt income for 5 years following the date of recognition for the amount of debt cancelled in 2009 and 4 years following the date of recognition for the amount of debt cancelled in 2010. The cancellation of debt income would then be included ratably over the 5-year period following the end of the deferral period. The change would be effective for debt that is repurchased, exchanged or deemed exchanged after December 31, 2008 and prior to January 1, 2011.

Prognosis

Many commentators and market participants believe that buybacks are here to stay. Regardless of the difficulties of amending existing documentation, there have been movements afoot to include buyback provisions in new transactions. This occurred, for example, in a July 2008 transaction for Booz Allen Hamilton Inc. led by Credit Suisse. The best evidence that buybacks are likely to endure is that the LSTA is in the preliminary stages of considering model terms.

DEFAULTING LENDERS

The U.S. savings and loan crisis that began in the early 1980s ended in the mid-1990s. During that period, there were approximately 1600 failures of commercial banks and 1300 failures of savings and loan institutions. In 1991 alone, 127 financial institutions failed or were assisted by the Federal Deposit Insurance Corporation (FDIC). That was the year that the Office of the Comptroller of the Currency declared the Bank of New England insolvent and appointed the FDIC as its receiver. Notwithstanding the fact that the Bank of New England was considered "too big to fail" – and all of its deposits (including those in excess of the then-$100,000 insured limit) were protected – the FDIC as receiver failed to perform lending obligations of the bank under many syndicated loan transactions. The failure prompted several of the largest arrangers of syndicated loans to introduce into their standard forms of syndicated credit agreements what were then called "the Bank of New England provisions," contemplating the possibility of defaults thereunder by lenders.

If these events seem familiar, it may be noted that there were 25 bank failures and assistance transactions in 2008 (through December 12), the highest number since 1993. This number does not include the failures of non-bank lenders, whose participation

in the bank loan market has exploded since the mid-1990s and taken on critical importance. Indeed, the most prominent failed lender in this market in 2008, Lehman Commercial Paper Inc., was not a bank and had approximately $11.4 billion of unfunded loan commitments at the end of the year. Failures and the difficulties that many lenders have encountered obtaining funds (whether or not they have failed) have led to defaults and fears of defaults by lenders in syndicated loan transactions. These defaults have sometimes resulted in lawsuits by borrowers seeking to compel performance[3] and have almost always raised issues under syndicated credit agreements that do not contemplate defaults by lenders. They have also prompted renewed attention to the forms of credit documentation used by many lead arrangers to address these issues (the provisions resulting from the Bank of New England case having long since disappeared by attrition).

Protecting Against Defaults By Lenders

The issues raised under syndicated credit documentation relate not only to the relationship between the defaulting lenders and the borrowers, but also to the respective relationships between the defaulting lenders and administrative agents, letter of credit issuers and swingline lenders, and other syndicated lenders. The new approaches taken or proposed to address these issues include one or more of the following features:

- MITIGATING CREDIT EXPOSURE TO DEFAULTING LENDERS HELD BY FRONTING BANKS. In syndicated credit transactions that include letter of credit and swingline facilities, issuing banks and swingline lenders extend credit to borrowers as fronting banks for other lenders. These extensions of credit are subject to participations held by the other lenders that are initially unfunded but may be required to be funded at a later time. Inherent in these facilities is that the fronting bank assumes the risk that other lenders may default when they are required to fund their participations. The principal mechanisms that have been introduced to protect fronting banks are (a) requiring the borrower to post cash collateral with the fronting bank in an amount equal to the defaulting lender's participation, (b) reallocating the participation of the defaulting lender among the non-defaulting lenders (subject to the limitation that the commitment of each non-defaulting lender not be exceeded) and (c) requiring the borrower to reduce the fronting bank's exposure by repaying swingline loans or procuring the reduction or termination of letters of credit in an amount equal to the defaulting lender's participation. In addition to a general requirement that these conditions be satisfied at any time a lender becomes a defaulting lender, their satisfaction may be an express additional condition precedent to the issuance, extension or increase of a letter of credit or to the making of a swingline loan. Some credit agreements may also allow a fronting bank to resign when one or more lenders have become defaulting lenders.

- ABILITY TO REMOVE DEFAULTING LENDERS FROM SYNDICATE. Although some "yank-a-bank" provisions in effect before the current financial climate already allowed borrowers to replace or remove lenders that failed to perform their lending obligations, many did not. The expansion of this right to cover defaulting lenders is now more prevalent.

- FORFEITURE OF FEES PAYABLE TO DEFAULTING LENDERS. Commitment fees, facility fees and letter of credit fees compensate a lender for being ready, willing and able to fund its obligations under a credit agreement when required. Accordingly, if a lender does not satisfy these obligations, it may forfeit its entitlement to these fees. To the extent that letter of credit exposure is reallocated among non-defaulting lenders (as described above), those non-defaulting lenders may share the portion of the letter of credit fee otherwise payable to a defaulting lender (and if that exposure is not reallocated, such portion may be payable to the issuing bank).

- DISENFRANCHISING DEFAULTING LENDERS. It is common for the credit exposure and commitments of a defaulting lender to be excluded for the purpose of determining whether the threshold of "Required Lenders" has been achieved, and to eliminate any requirement for obtaining the consent of a defaulting lender under circumstances where unanimous consent (or consent from "affected" or "directly affected" lenders) would otherwise be required. An exception may be made for certain fundamental matters such as reducing the rate of interest or fees payable to a defaulting lender or extending a scheduled payment date, or reducing the principal, of any amount owing to a defaulting lender.

- APPLICATION OF PAYMENTS. It is also common for amounts received from a borrower by an administrative agent for the account of a defaulting lender to be applied first, to the administrative agent for amounts due and payable by the defaulting lender to the administrative agent

3 See, for example, Hexion Specialty Chemicals Inc. v. Credit Suisse, No. 08-114512 (Sup. Ct. N.Y. Cty. Oct. 31, 2008)

(principally indemnities and expense reimbursement) and then to the fronting banks for amounts due and payable by the defaulting lender to the fronting banks (principally amounts to fund participations and overdue interest thereon). Before any remaining portion of such amounts is paid to the defaulting lender, a part thereof may be held as cash collateral by fronting banks for outstanding participations of the defaulting lender not yet due and payable and/or applied to obligations due and payable by the borrower to the non-defaulting lenders (thereby effectively subordinating the claims of the defaulting borrower to the claims of the non-defaulting lenders).

- REPLACEMENT OF ADMINISTRATIVE AGENT. If the defaulting lender is the administrative agent, the borrowers and the lenders may be concerned that its back office administrative capabilities may become impaired and/or that funds received by it in its capacity as administrative agent may be trapped as part of any insolvency proceedings of which it may become the subject. Accordingly, the lenders may wish to have the right (by action of the "Required Lenders") to replace any defaulting lender acting as administrative agent.

Defining a "Defaulting Lender"

The definition of "defaulting lender" is fundamental to the application and efficacy of the foregoing protective provisions. At a minimum, one would expect this definition to include any lender that (a) has failed (after a grace period) to comply with its obligations to fund a loan or participation or (b) has become the subject of a bankruptcy or insolvency proceeding or has had a receiver, trustee or similar entity appointed in respect of its assets. Additional trigger events may include (i) notice or public declaration by a lender that it will not comply with those obligations (either under the applicable credit agreement or under another similar credit agreement to which it is a party), (ii) failure by a lender to confirm to the administrative agent (in response to a specific request) that it will comply with those obligations, (iii) downgrade of a lender's credit rating below a specified level and/or (iv) the occurrence of any of the events referred to above in this paragraph with respect to a parent company or material subsidiary of a lender. The definition will strike a balance between protecting the other parties in the transaction at the earliest possible time and setting a trigger event that is so early as to be unfair to the borrower (who may be forced to post cash collateral or lose a portion of its benefit under the facilities) and/or a lender (who may not have actually defaulted yet). In this regard, it may be possible to have two separate definitions – a "Defaulting Lender" and a "Potential Defaulting Lender" – with the most draconian consequences reserved for the former. For example, it may be regarded as unfair to disenfranchise a lender or to take away its fees if it has not actually defaulted yet, but at the same time allow fronting banks to seek additional credit protection when a default seems likely. In this regard, early trigger events should be identified bearing in mind that, for any lender that is an eligible debtor under the U.S. Bankruptcy Code (which would not include banks), a trigger consisting solely of such lender's becoming the subject of a bankruptcy case (a so-called "ipso facto clause") might not be enforceable and therefore would be too late, and remedies exercised after the commencement of such a case may be subject to an automatic stay.

Market Acceptance

Because of the current state of the bank loan market, it is difficult to assess the acceptability of some of the provisions described above. There have been very few new leveraged transactions in which to test them, and some investment grade borrowers may still have sufficient bargaining power to resist disadvantageous provisions. Where attempts are made to introduce these provisions by amendments to existing transactions, it is necessary to undertake a careful analysis of the applicable documentation to distinguish between those amendments that require unanimous consent (or consent from "affected" or "directly affected" lenders) and those that require consent only from a specified percentage of lenders. The general difficulty of obtaining unanimous consent in the current market conditions will almost certainly be exacerbated if a consent is required from a lender that is the subject of a bankruptcy case or FDIC receivership, since obtaining it may be a lengthy and cumbersome process.

LIBOR MARKET DISRUPTION

Lenders in the bank loan market suffered frustration in 2008 over the fact that the publicly quoted LIBOR was at some times lower than the actual rates they pay for Eurodollar deposits, if they were able to obtain those deposits at all. U.K. banks questioned the reliability of publicly quoted LIBOR at a meeting with the Bank of England as early as November 2007, and two economists at the Bank of International Settlements raised similar concerns in a report in early 2008. The global reach of this problem was demonstrated in a recent survey of banks in Asia showing that 19 out of 26 respondents reported a discrepancy between publicly reported LIBOR and their costs of funding U.S. dollars.

The British Bankers' Association (BBA) oversees the public quotation of LIBOR by designating a panel of 16 U.S. and non-U.S. banks to furnish their rates to Thomson Reuters, which publishes the average after eliminating the highest and lowest rates. Several reasons have been proposed for the disparity between this publicly quoted LIBOR and actual Eurodollar deposit rates. The most often cited is that banks on the BBA's panel have been reluctant to report their true, higher cost of funds because it may be interpreted as a desperate need for cash. Also, the Eurodollar market has been relatively thin, particularly for deposits with longer tenors. Banks have been more willing to lend funds to each other overnight or for other short periods than for longer periods such as three or six months. Thus, rates quoted by the panel banks for longer term deposits may contain some element of artificiality and may not be completely reliable. A third possible reason is that, since U.S. banks are the principal source of U.S. dollars, the brunt of the illiquidity in the interbank market is borne by non-U.S. banks. In the fall of 2008, many European banks were paying the double the rates paid by U.S. banks for overnight deposits.

Explanation of the Market Disruption Clause

The risk that the quoted LIBOR rate might not reflect the lenders' funding costs has been contemplated by most credit documentation since the 1970s, when LIBOR-based lending began, and is addressed in what is often referred to as "the market disruption clause". The original purpose of the clause was to protect lenders against exactly the circumstances described above, either (a) the quoted LIBOR rates are somehow "tainted", in that they do not reflect actual market rates, or (b) a tiering has occurred within the bank ranks resulting in some banks incurring higher costs than others to obtain Eurodollar deposits. A typical provision reads in relevant part as follows:

> *If prior to the commencement of any Interest Period for a LIBOR Borrowing . . . the Administrative Agent is advised by the Required Lenders that LIBOR for such Interest Period will not adequately and fairly reflect the cost to the Lenders of making or maintaining the Loans for such Interest Period, then the Administrative Agent shall give notice thereof to the Borrower and the Lenders as promptly as practicable thereafter and, until the Administrative Agent notifies the Borrower and the Lenders that the circumstances giving rise to such notice no longer exist, (i) any request to convert any Borrowing to, or continue any Borrowing as, a LIBOR Borrowing shall be ineffective and (ii) any requested LIBOR Borrowing shall be made as an ABR Borrowing.*

This provision has two principal components. The first component is the trigger event that entitles lenders to suspend making loans bearing interest at rates calculated by reference to LIBOR. In the sample clause above, it may be invoked by "the Required Lenders," which is typically either a majority or at least 66 2/3% in interest. In contrast, British-style syndicated credit agreements often require a lower percentage -- perhaps as low as 30%. The importance of using a minimum percentage, and the level of the percentage used, is to strike a balance between providing real protection to the lenders and subjecting the borrower to idiosyncratic conditions affecting only one or very few of the lenders.

The second component of this provision is the consequence of lenders having invoked their rights. In the sample clause above, the consequence is that all loans otherwise bearing interest calculated by reference to LIBOR instead would be Base Rate borrowings. The reason that Base Rate pricing is used as the fallback when LIBOR does not reflect the cost of funds is that the Base Rate has, until recently (as discussed more fully below), always exceeded LIBOR. In many syndicated loan transactions where the borrower is not U.S.-based and syndication takes place primarily outside of the United States, the Base Rate interest option is not available. In these cases, the consequence of lenders having invoked their rights under the market disruption clause is that each lender is entitled to charge interest on its loans equal to its cost of funds plus its profit margin. The cost of funds is generally not defined, but each lender is usually required to certify its cost to the borrower.

Application of the Market Disruption Clause

It is difficult to remember whether the market disruption clause has ever been invoked before the current period of financial stress. In the early 1990s, when the Japanese economy slipped from a dominant position, many Japanese banks paid premiums in order to attract Eurodollar deposits, pushing their costs of funding above the rates paid by leading banks from other parts of the world. At that time, the prevailing practice was for LIBOR to be calculated under credit agreements as the average of the Eurodollar deposit rates quoted by several (usually from two to five) "Reference Banks" in the lending syndicate, rather than the current practice of using a published rate. However, the number of affected banks was generally below the threshold of "Required Lenders" and the market disruption clause was never invoked. Instead, where the opportunity arose, credit agreements were amended or new credit agreements were entered into providing for the Reference Banks to include Japanese

banks so that the Japanese premium would be taken into account in calculating LIBOR.

Later, during the Asian financial crisis of the late 1990s, the market again imposed a premium on deposits in certain banks. At that time, affected banks frequently sought legal advice about their rights under the market disruption clauses in their credit documentation. The number of affected banks was again generally insufficient to invoke the market disruption clause. This resulted in increased pressure on borrowers to reduce the threshold required to invoke the clause in future transactions, but we are not aware of any cases where it was in fact successfully invoked.

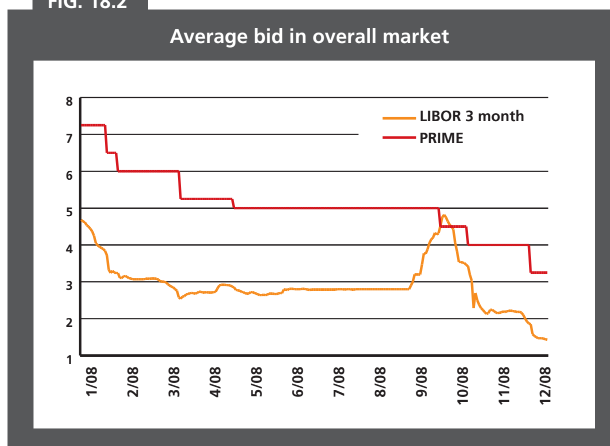
During the current period of LIBOR market disruption, lenders and their leading industry groups have devoted countless hours considering how to address the problem. On October 7, 2008, for example, the LSTA hosted a conference call devoted solely to this subject in which almost 750 callers from around the world dialed in.[4] Yet, despite the frustration expressed by many lenders, we are aware of only a small number of cases – mostly in Asia – where the market disruption clause has been successfully invoked. Several possible explanations have been proposed for the failure of the clause to be invoked, including:

- REPUTATIONAL RISK: Just as banks on the BBA's panel may not wish to report their true, higher cost of funds because it may be seen as reflecting the level of their need for cash, lenders in syndicates might not wish to be seen as having higher than average costs of funds.

- CURE WORSE THAN THE DISEASE: Although, as noted above, LIBOR has always been higher than the Base Rate in the past, the relationship between these rates inverted for a short period in 2008. (See figure 2.) Accordingly, where a credit agreement contemplates Base Rate pricing as the fallback when LIBOR does not reflect the cost of funds, invoking the market disruption clause may have the ironic effect of lowering returns. In credit agreements where the market disruption clause would entitle each lender to impose its own cost of funds, there are other drawbacks. First, banks are quite sensitive about disclosing their cost of funds for competitive and reputational reasons, and this may be a particularly delicate issue for lenders that are also members of the BBA's panel. Second, even though credit agreements normally provide some level of exculpation for lenders in quoting these rates, the risk remains that a quote could be challenged.

FIG. 18.2

Average bid in overall market



Source: LSTA/LPC MTM pricing

- CUSTOMER RELATIONSHIPS: Because the market disruption clause has never been successfully invoked before this period of turmoil, and because even now it is seldom invoked, lenders may be concerned about strong negative reactions from borrowers. Indeed, the British Association of Corporate Treasurers published a press release on September 28, 2008 discouraging lenders from invoking the clause, except as a last resort.

- DIFFICULTY COORDINATING ACTION: Even though the current Eurodollar market conditions appear to affect a larger number of banks than in the past, some banks have expressed the view that it is difficult either to coordinate action or to achieve the threshold number of banks required to invoke the clause.

Prescriptions for Change

The British Bankers' Association issued a report dated November 17, 2008 entitled "LIBOR Governance and Scrutiny" proposing a methodology for improved monitoring of publicly reported LIBOR. Its proposals include the creation of two new subcommittees: the Fixings Subcommittee would be charged with scrutinizing the quotations furnished by panel banks with a view towards identifying questionable data and arranging follow-up discussions with quoting banks when appropriate, and

4 The Loan Market Association (LMA), based in London, hosted a similar discussion for its members during the week of September 27, 2008, and the Asia Pacific Loan Market Association (APLMA), based in Hong Kong, hosted a meeting on the topic for its members on October 16, 2008.

the Oversight Subcommittee would be charged with sanctioning quoting banks when they are found to be out of compliance with required procedures for providing quotations. In addition, the Foreign Exchange and Money Markets Committee, with the overarching responsibility for the BBA's determination of LIBOR, would be expanded to include representatives from a non-quoting U.S. bank, a non-quoting European bank, the London International Financial Futures and Options Exchange, the Chicago Mercantile Exchange, an institution in the fund management industry and the U.K. Association of Corporate Treasurers. Also, under the proposals Thomson Reuters would be charged with the responsibility of analyzing rates furnished to it against specific standards and reporting aberrations to the Fixings Subcommittee. The proposals continue to be under review and have not yet been finalized.

In the meantime, the difficulties associated with invoking the market disruption clause have prompted suggestions for change. The suggestions fall into three categories: changing the LIBOR calculation, changing the trigger event to invoke the market disruption clause and changing the consequence of invoking the market disruption clause.

Suggestions for changing the LIBOR calculation include (1) imposing a floor for purposes of calculating LIBOR under credit documentation, (2) abandoning the published rate announced by Reuters and reverting to the former practice of using an average of rates quoted by specified "Reference Banks" for purposes of calculating LIBOR under credit documentation and (3) prevailing upon the British Bankers' Association to modify its definition of LIBOR or to expand its panel of quoting banks. Imposing a LIBOR floor has the advantages of increasing the yield under current market conditions and being easy to apply, and it has been adopted in many transactions. However, it is a somewhat blunt instrument, since a fixed floor does not adjust for changing market conditions. Using selected Reference Banks may provide the most flexible tool to diversify the source of LIBOR quotations for a particular transaction, but if banks are quoting inaccurate rates to Reuters it is unclear whether the rates quoted under a credit agreement would be more reliable, and this suggestion does not appear to have attracted much interest. In September 2008, the BBA reportedly rejected many suggested changes to its calculation of LIBOR after considering them for almost two months. However, it committed at that time to proceed with plans to ensure accuracy in the rates obtained from panel members, resulting in its report referred to above.

The principal suggestions for changing the trigger event in the market disruption clause have been (1) lowering the percentage of lenders in interest required to invoke the clause and (2) introducing an additional trigger event based upon an objective standard. In January 2009, the Asia Pacific Loan Market Association issued a set of recommendations to its members concerning the market disruption clause. Among those recommendations was the suggestion that the percentage of lenders in interest required to invoke the clause be in the range of 20% to 35%. Similar suggestions have not taken hold in the U.S. markets. An additional trigger event based upon an objective standard, for example a deviation between LIBOR and U.S. Treasury rates or federal funds rates has several advantages. By removing the subjective factor from the determination, (a) banks will not have to reveal their particular costs of funds, (b) borrowers will have greater confidence that they are being treated fairly and (c) the risk to borrowers of lowering the percentage of lenders in interest entitled to invoke the clause is less acute. Notwithstanding these advantages, the market has not adopted this suggestion, perhaps because of the additional complexity it would entail.

Possibilities for changing the consequences of invoking the market disruption clause include (1) modifying the definition of "Base Rate" to ensure that it is not below LIBOR and (2) increasing the spread. Suggestions have been made to change the definition of "Base Rate" to be the highest of several benchmarks. These benchmarks would include the two that are prevalent today (the prime rate and the federal funds rate plus 50 basis points), as well one or two others. The possible additional benchmarks are LIBOR and (less common) a secondary certificate of deposit rate, each for a defined period of, say one month, as determined on each day for which interest is payable. While at first blush an additional benchmark based on LIBOR may seem redundant – after all it is only relevant if LIBOR does not reflect the cost of funds to begin with – it may in fact provide an important benefit. LIBOR quotes are more likely to be problematic for longer tenors, where the different risk profiles of banks becomes more significant. Accordingly, if the tenor for the LIBOR quote used for purposes of the definition of "Base Rate" is sufficiently short, it is less likely to present an issue. An additional advantage of this change is that it would discourage borrowers from selecting Base Rate borrowings when the prime rate is less than LIBOR. The possibility of adding an incremental spread when the market disruption clause is invoked has the some of the same advantages and disadvantages as those described above in connection with a LIBOR floor. While it will increase the yield under current market conditions, there is no assurance that the

amount of the increase would be sufficient under different market conditions. Also, a spread set high enough to compensate for even more tumultuous conditions may encounter resistance from borrowers.

How the market continues to react to the possibility of LIBOR market disruption may depend in large part on the final form of the BBA's report referred to above and whether it engenders the confidence sufficient to avoid the need for further measures.